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___ Discussion

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SUBJECT: **FEDERAL LEGISLATIVE UPDATE**

STAFF CONTACT: Joyce Nichols, City Manager's Office, 452-4225

POLICY ISSUE: Congress, the Administration, and federal agencies each year approve actions that impact the City in a broad range of areas. Staff may recommend, and/or Council may wish to direct, communication to the City's Congressional delegation on a range of issues throughout the year.

DIRECTION NEEDED FROM COUNCIL: This briefing provides information on the current activities of Congress. The information comes from a report provided by federal lobbyist Vicki Cram.

BACKGROUND:

The 2012 election results were important for the Northwest in several ways: Senator Patty Murray may become the new chair of the Senate Budget Committee; Representative Cathy McMorris-Rodgers will be the highest ranking Republican woman in Congress; and due to redistricting, which shifted Congressman Dave Reichert's district further east, Bellevue is now represented by Congressman Adam Smith in the House of Representatives.

With President Barak Obama having been reelected and the Senate and House having stayed in Democratic and Republican hands, respectively, the President and the Congress have turned their attention to dealing with the big items like the "fiscal cliff" issues—the combination of expiring 2001 and 2003 tax cuts, payroll tax holiday, the individual Alternative Minimum Tax (AMT), and several others that expire December 31, 2012; and the automatic $109 billion in spending cuts scheduled to take effect January 2, 2013 per the Budget Control Act. What remains unclear is how much can or will be accomplished in this "lame duck" session. Because much of what will happen next year will be driven by what happens in the next two months, the balance of this report discusses the challenges facing the President and the Congress in the lame duck session.

To put matters in perspective: Unless current law is amended, all of the Bush tax cuts will expire at the end of the year, as will various other temporary tax provisions (e.g., AMT relief for middle class Americans, extension of estate tax relief, and a variety of tax credits that are enjoyed by individuals, as well as the R&D tax credit and a host of other tax credits relied upon by the business community). Congress and the Administration also must decide how to protect physicians serving Medicare patients from sustaining steep cuts in reimbursement rates and whether to extend enhanced unemployment insurance for the long-term unemployed. In addition, decisions need to be made whether to extend, replace, or allow to lapse the two percentage point payroll tax cut for all working Americans. Finally, $109 billion in across-the-board spending cuts ("sequestration") mandated by the Budget Control Act of 2011 will begin to kick in on January 2. Half of the automatic spending cuts will hit the Pentagon, while the other half will reduce spending by the rest of the government, with most agencies facing funding cuts of 8.2%. In popular parlance, the United States will fall off a "fiscal cliff" with potentially no safety net in place unless the President and the Congress agree to amend current law.

Recognizing the dangers to the economy, the Administration reportedly is analyzing the extent to which it could use existing authority to buy additional time to reach an agreement with Congress early next year, such as by freezing the amount of money taken out of payroll checks by not updating tax withholding tables to reflect expiration of the Bush tax cuts on December 31. The Administration also could seek to delay to later in the year automatic spending cuts that otherwise would begin on January 2. We do not expect the Administration to make its plans public any time soon, not least because identifying an escape hatch early could create the very outcome it hopes to avoid. And, in any event, it doesn't have to come to this.

A great deal was accomplished in the lame duck session of 2010, in large part because Democrats and Republicans agreed to compromise. Both sides recognized that the economy needed a boost and that, by working together, they could resolve issues that until then had eluded resolution. In that environment, the President agreed to extend all the Bush tax cuts, as well as to extend other expiring or expired tax provisions, such as AMT relief. He also succeeded in pushing a major arms control treaty through the Senate. We expect a comparable effort this time as well, though the details on the tax policy side will likely be subject to intense negotiations, particularly on whether to limit extension of the Bush tax cuts to a particular income threshold.

To date, Congress has been unable and unwilling to agree to do anything, in part because of intransigence by both parties over whether to impose an income limit on an extension of the Bush tax cuts and in part because the "cost" of extending current law has been well beyond what Congress has been willing to "pay." As one example, a two-year extension of an AMT patch for middle-class families plus routine extension of expired and expiring tax provisions would cost $205 billion. In addition, delaying sequestration for an additional year would require $109 billion in new revenues or cuts to non-targeted programs (unless, of course, Congress punted by forcing nine years of cuts into eight, increasing the pain in future years).

Over the last year, there has been bipartisan agreement that the fiscal cliff must be avoided and that a comprehensive overhaul of the tax code is necessary. Nonetheless, the parties have fundamentally disagreed about how to approach these issues, with President Obama and Congressional Democrats arguing for significant tax increases as a means of deficit reduction and Governor Romney and Congressional Republicans rejecting the idea that any direct tax increases are necessary, preferring that any new revenue come from assumed economic growth once tax reform is enacted.

The result has been a continued legislative stalemate, with a heavy dose of political posturing by both sides. But even close elections can be clarifying. A narrowly divided electorate now having spoken, we expect discussions to begin anew with some urgency in the lame duck session. Given major philosophical differences on tax policy issues between the parties, it remains to be seen whether these discussions will lead to an agreement to avert the fiscal cliff while, at the same time, clearing the way for comprehensive tax reform. In our view, it is likely both will occur in the lame duck session (or shortly thereafter), beginning with agreement on a Bush tax cut extension coupled with a broad framework for a tax reform agreement, with the hard work of tax reform to span across 2013. Although there are a range of possible outcomes in the lame duck session and beyond, one thing is certain: in stark contrast to the last year, over the next few months we will finally see the parties undertake a serious discussion about tax policy.

In the lame duck session, for example, Congress might agree to legislation that would extend all (or most) expired and expiring tax breaks for six months to a year, tied to fundamental tax reform generating some agreed-upon amount in the hundreds of billions of dollars (or more) in overall deficit reduction over the next decade, with the threat of greater deficit reduction if the 113th Congress were to fail to act by then. Democrats will likely raise eliminating or modifying some tax measures, including those aimed at the oil and gas industry, to help offset the cost of forestalling the spending sequester or to make a "down payment" on future deficit reduction. Such an agreement also could mandate some further level of deficit reduction by seeking to compel the 113th Congress to reform entitlement programs such as Medicare and Medicaid next year.

Forcing hard decisions as a means of achieving deficit reduction of course is what the Budget Control Act of 2011 was supposed to accomplish by establishing the "Super Committee" and creating the threat of sequestration next year if Congress failed to agree to legislation reducing the deficit by at least $1.2 trillion over a decade. And it is precisely that failure that has the nation confronting the fiscal cliff. Many Senators and Representatives recognize the irony that the best way to prevent going over the fiscal cliff this year is to cut a deal that merely creates a bigger cliff that would arrive in another six or twelve months. But doing so would at least keep us at the precipice.

With the elections behind them, the President and the 112th Congress have an opportunity to succeed where they have failed before. Assuming Congress is willing to support legislation putting off the day of reckoning for an additional six months to a year, we expect the President to ask for an increase in the debt ceiling as part of the final negotiations. (As a result of increased tax receipts, the Treasury Department now anticipates that the debt ceiling will not be reached until early in the first quarter, with action to address the problem probably necessary by late February or early March.) Whether the President can secure congressional support for an increase by the end of the year will be a matter to be negotiated and ultimately will depend on the magnitude of whatever deal is reached. The President will not want to ask Congress to increase the debt ceiling early next year in a situation in which House Republicans would be in a very strong position to extract additional concessions without having to give up something meaningful. For them, the trade off in the lame duck session might be a one-year extension of the Bush tax cuts, including for married couples making more than $250,000, tied to an agreement to pursue fundamental tax and entitlement reform next year. Even that might be a stretch. Given the election results, Congressional Republicans may have to accept an income limitation for any Bush tax cut extension, if not at $250,000 then at $500,000 or $1,000,000.

What else beyond addressing the fiscal cliff can we expect Congress to accomplish during the lame duck session? Unfortunately, not much. Senate Majority Leader Harry Reid intends to bring some form of Cybersecurity legislation to the Senate floor, but we have our doubts that a bill can get through two houses and to the President by the end of the year. The leadership of the Armed Services Committees will endeavor to move a defense authorization bill that would not be subject to contentious amendments on the floor. Beyond that, a backlog of noncontroversial bills has been building for a long time, but most if not all of them will have to move in the Senate by Unanimous Consent.

When it adjourned for the elections, the 112th Congress had approved only 196 bills that were enacted into law, well below the output of the 104th Congress, which produced legislation resulting in 333 public laws. Along with many others, we will be pressing to get things done in an environment we hope will be more hospitable to legislating than the first 22 months of the 112th Congress.

In our State of the Union Analysis this past January, we pointed out that "[t]he first session of the 112th Congress is likely to be remembered as one of the least productive in decades." When the President signed the National Defense Authorization Act for FY 2012 on New Year's Eve, it became Public Law No. 112-81. Having fallen seven short of the 88 bills enacted in 1995, the first session of the 112th Congress produced the fewest number of public laws since Congress formally began keeping track in 1947. With a flurry of signatures on January 3, however, the President helped this Congress eke out of last place with a total of 90 bills signed into law in the first session. Having barely picked up the pace since then, the 112th Congress is now on track to be the least productive ever as measured by bills enacted into law. Congressional Republicans would argue that the slow pace of legislation is the natural and desired result of divided government. But the public's record low approval rates for this Congress no doubt reflect the perception that partisan activity has prevented necessary legislation from becoming law.

What else can we expect in the next few months? With the President having won re-election, we anticipate that many major rules will soon be published in final form, which will likely trigger a political reaction on Capitol Hill as Republicans invoke the Congressional Review Act in an effort to block them from becoming law. The EPA, for example, has many major rules on track to become final later this year or early next year. In addition, dozens of rules required under the Dodd-Frank Act are in the works. Finally, the President's re-election puts his Administration in a commanding position to finalize numerous rules that solidify the regulatory framework for implementing the Affordable Care Act. Republican efforts to invoke the Congressional Review Act later this year and next year are unlikely to succeed in the Democratic-controlled Senate. Even if one or more do, a certain Presidential veto virtually ensures forthcoming rules will stand unless struck down by the courts.

In its next term, the Administration is likely to face high Cabinet turnover, beginning early in 2013, not least because so many senior officials have been in position so long. (Turnover to date has been historically low for the post-World War II era.) In addition to moving forward with his regulatory agenda, the President may be able to effectuate long-lasting policy changes through Supreme Court and lower-court appointments as well. Four Supreme Court Justices, for example, are in their mid-to-late 70s and could opt to retire prior to the end of the President's second term.

On Capitol Hill, there will be a great deal of turnover, in particular among Republicans currently serving in committee leadership positions. This will provide the Administration with an opportunity to forge some new relationships in the 113th Congress. In the Senate, Republican caucus rules limit time served as a Ranking Member to six years (and time served as a Chairman to an additional six years). While most current Ranking Members have time left to serve as chairmen, many of them are completing their sixth year as the Ranking Member, which will lead to a significant reshuffling of the decks for the 113th Congress.

As a result of House Republican Caucus term limit rules, we expect to see as well a great deal of turnover among Republicans chairing House committees. In fact, of the Members who are completing six years of service, House Budget Committee Chairman Paul Ryan might be the only Member to secure a waiver to serve an additional two-year term.

Except for changes triggered by retirements, all Senate Democratic Chairmen will maintain their gavels in the new Congress since they are not subject to term limit rules. Only the Budget Committee, the Energy and Natural Resources Committee, the Homeland Security and Governmental Affairs Committee, and the Veterans' Affairs Committee will likely have new leaders. Among House Democrats, there will be a similar level of continuity, with little turnover among Members serving as Ranking Members.

With the balance of this analysis, we offer our thoughts on major policy areas that will drive the agenda in Washington for the next two years and thus how potential developments might affect you. Given the still narrow margin enjoyed by Senate Democrats, not much will get through the Senate unless each party commits to putting aside partisan differences to get something done on the deficit, fundamental tax reform, and a host of other pressing national issues. Under Republican control, the House leadership will be in a strong position to move whatever their membership supports. But bills written with only the interests of one party in mind stand virtually no chance of moving in the Senate, as House Republicans have seen over and over again in the 112th Congress.

Ironically, the voters have elected a 113th Congress that may be even more partisan than the 112th Congress, at least on paper. Both chambers will have a substantial number of new Members, in part because of redistricting and because so many Senators and House Members have thrown in the towel over their dismay that so little gets done anymore. (The House, for example, had 62 Districts in which an incumbent was not on the ballot.) By casting their votes, we have a sense the public wants the 113th Congress to get something done, to address the big issues that confront the country, and to do so working together.

Now that the voters have spoken, will the 113th Congress keep in mind Thomas Jefferson's advice and make more of an effort to cross ideological divides, compromise, and solve the major policy challenges that confront our nation? As Jefferson recognized, major policy changes demand broad support to be successful. Addressing the deficit, for example, is too important and too big an issue for one party to hope to dictate the outcome to the other. We thus remain optimistic that the President and the Congress will work together in the lame duck session and establish the framework by which they can continue to work together next year.

Among the big issues likely to be addressed by the President and the 113th Congress is one we think worth mentioning here: immigration reform. There is broad support in the business community for Congress to finally address the issue. Leaders of the high-tech community, for example, have been calling on Congress for years to adopt legislation that would help them attract skilled engineers and software programmers, especially those who have graduated with advanced degrees from American universities and then are forced to return to their home countries. Moreover, the demographics of the voting population are changing so dramatically that neither party can risk failing to address the issue before the next Presidential election. In an interview with the Des Moines Register last month, the President signaled that he wants to take up the issue once the deficit has been addressed. He made the case for reform on both substantive and political grounds, saying in part: "I am fairly confident that [Republicans] are going to have a deep interest in getting that done." As part of this effort, we expect there to be a renewed focus on the DREAM Act, which removes certain barriers to access for undocumented children who wish to attend college. Senator Marco Rubio (R-FL), who has expressed great interest in crafting a compromise, may lead the Republican effort, possibly joined by two incoming Republican Senators from Southwest border states—Ted Cruz of Texas and Jeff Flake of Arizona. As in addressing the deficit and fundamental tax reform, both parties will need to compromise to get something meaningful done. A policy change of this magnitude simply cannot be forced on a slender majority.

MAJOR ISSUES: TAX POLICY

Over the last year, election politics have weighed heavily on the tax policy debate. There has been broad agreement among Republicans and Democrats that the fiscal cliff must be avoided and that a comprehensive overhaul of our tax code is necessary. At the same time, the parties have strongly disagreed on how to approach these issues, with President Obama and Congressional Democrats arguing for significant tax increases as a means of deficit reduction and Governor Romney and Congressional Republicans rejecting the idea that tax increases are necessary, preferring that any new revenue come from assumed economic growth once tax reform is enacted. The result has been a continued legislative stalemate, with a heavy dose of political posturing by both sides.

A narrowly divided electorate now having spoken, we expect discussions to begin anew in the lame duck session. Given major philosophical differences on tax policy issues between the parties, it remains to be seen whether such discussions will lead to an agreement to avert the fiscal cliff while, at the same time, paving the way for comprehensive tax reform. In our view, it is likely both will occur, beginning with an agreement in the lame duck session (or shortly thereafter) on a Bush tax cut extension coupled with a broad framework for tax reform, with the hard work of detailed reform to span through 2013. Although there are a range of possible outcomes in the lame duck session and beyond, one thing is certain: in stark contrast to the last year, over the next few months we will see the parties undertake a serious discussion about tax policy.

Bush Tax Cuts Extension. The first order of business in the lame duck session will be preventing the country from toppling over the fiscal cliff presented by the looming expiration of the Bush tax cuts and automatic spending cuts (sequestration), both of which, absent a signed law to the contrary, will take effect in January 2013. The Bush tax cuts, enacted in 2001 and 2003 and extended several times since then, include individual marginal, capital gains, and dividend tax rates, as well as a host of other provisions. Last extended for two years at the end of 2010, they are set to expire and revert to pre-2001 rates should Congress not affirmatively take action to extend them by December 31, 2012.
If the Bush tax cuts were to expire:

- All individual marginal tax rates will increase, with the lowest bracket rising from 10 to 15 percent and the highest marginal tax rate rising from 35 to 39.6 percent;
- The tax rate on qualified dividends will rise from 15 percent to a maximum rate of 39.6 percent;
- The maximum rate on long-term capital gains will rise from 15 to 20 percent;
- The estate tax will revert from a $5.12 million individual exemption with a 35 percent rate to a $1 million individual exemption level and a 55 percent maximum rate;
- Limitations on itemized deductions and personal exemptions will be reinstated for upper-income individuals; and
- The child tax credit will be reduced from $1,000 to $500 per child.

Rather than allow such a reversion to occur, President Obama will likely request that Congress pass during the lame duck session a one-year extension of the Bush tax cuts limited to income below $200,000 (in the case of single filers) and $250,000 (married filers). This has been the President's preferred approach since the 2008 campaign, and his position has only hardened since the end of 2010, when Congressional Republicans, fresh off of a sweeping electoral victory, forced the President's hand by demanding he sign a two-year straight extension. Over the last two years, the President's consistent threat to veto any legislation that deviates from his stated policy could not be clearer.

Given the attention paid to this issue in the 2012 elections, and before that during debt ceiling and Super Committee negotiations in 2011, the President may firmly believe that, having won a hard-fought campaign, his position should prevail. What is far from clear, however, is whether Congressional Republicans will acquiesce to this demand. The House Republican majority, in particular, might be in no mood to agree to this. They, along with their Senate Republican colleagues, are likely to insist upon a one-year straight extension of the Bush cuts. Given their continuing majority in the House, they will argue that the President does not have a clear mandate on fiscal issues.

Even if both sides are willing to compromise, negotiations will be neither easy nor quick. For the Administration, an opening bid might include a commitment to reform the tax code while reducing entitlement spending in 2013, tied to an insistence that all the Bush cuts are eliminated, now and forever, for income above $200,000/$250,000. For Congressional Republicans, an opening bid might include a willingness to discuss raising revenue as part of tax and entitlement reform next year, predicated on a straight one-year extension of the Bush tax cuts in the interim. It is doubtful either position will take flight, at least initially during the lame duck session. But if neither side budges from its pre-election position, the fiscal cliff has real potential to materialize.

This potential collision no doubt looks like a virtual replay of the clash between the President and Congressional Republicans that dominated the last two years of the President's first term. In fact, it could be. However, elections, even close ones, can be clarifying events, and in this instance failure to move past rigid ideological differences is a recipe for fiscal calamity both parties want to avoid. They now have an opportunity to demonstrate that they are willing to compromise in an effort to avert disaster.

Assuming, as we do, that serous negotiations will occur, what might compromise look like? A first step could be a willingness to extend the Bush cuts for one year, either income limited or not (at, for example, $500,000-$1,000,000), while including a process with agreed-upon numbers for revenue-raising tax reform and entitlement spending reform in 2013. Tax reform could both raise revenue for deficit reduction purposes, as desired by President Obama and Congressional Democrats, while broadening the tax base and lowering marginal rates, as Congressional Republicans have insisted upon. Entitlement reform would allow Congress to tackle the most significant drivers of the long-term debt, consistently championed as necessary by most Congressional Republicans, and increasingly acknowledged as necessary by the Administration and some Congressional Democrats.

Such an agreement, which could be similar to the "grand bargain" contemplated by Speaker Boehner and President Obama in 2011, would give both sides a good measure of what they want, while allowing for some compromise. This would represent a significant step forward in the beginning of a second Obama term by which the President would demonstrate he is serious about governing, and Congressional Republicans would acknowledge that they cannot achieve their goals without working with the incumbent President. And yet, and yet.

Grand bargains being elusive as they are, it is also possible that the President and Congress will agree to a stop-gap measure extending the Bush cuts (likely with an income limitation) for a period of months, or perhaps a year, leaving bigger decisions surrounding tax and entitlement reform to next year. Or, in the worst case scenario, current tax policy could plausibly expire at the end of the year, with Congress and the Administration left to pick up the pieces come January.

With respect to process and timing, much is to be determined. While both sides surely want to avoid a fiscal catastrophe, it remains to be seen whether compromise can occur this year. It is worth noting that if an agreement is not reached in November or December, both sides will have plenty of opportunities to engage early next year when the current authorization for the debt ceiling is expected to be breached, currently anticipated to occur sometime around March.

Should a deal be reached that extends the Bush cuts (of the grand bargain variety or otherwise), it could be enacted in several different ways. Both the House and Senate have already passed differing versions of legislation extending the Bush tax cuts through 2013 (though for reasons pertaining to Constitutional authority, the Senate bill will continue to sit at the Senate desk). The House bill, H.R. 8, extends all the Bush tax cuts and patches the alternative minimum tax (AMT) for individuals, also through 2013. However, H.R. 8 does not include any of the traditional business, individual, and energy tax "extenders," such as the research and development credit and active financing exception that expire on a year-to-year basis. In addition to any changes limiting the Bush tax cuts to an income threshold, it is likely that final legislation will incorporate most of those provisions, extending them through 2013 (though it is possible that some extenders will be modified or left to lapse).

Immediately after passing H.R. 8 in early August, the House also passed H.R. 6169, which would create a bicameral expedited legislative process for tax reform in 2013, whereby the House and Senate would be forced to vote on legislation under specific timelines, with no Senate filibuster. This, too, could be incorporated in some form or fashion into an end-of-year bill, depending upon the scope of agreement reached.

Comprehensive Tax Reform. Over the last two years, the possibility of comprehensive reform of the Tax Code, last accomplished over two decades ago in 1986, has progressed from chatter amongst tax policy leaders to seeming near inevitability. It has been discussed frequently in the House, the Senate, and the Administration, while also permeating Presidential and Congressional election rhetoric. But while both Republicans and Democrats agree that corporate tax reform generally should be revenue neutral, significant disagreements on revenue persist in connection with individual reform. President Obama, along with House and Senate leaders, will have to agree upon a basic framework in order for tax reform to proceed in a meaningful manner. Whether in the lame duck session or afterwards, President Obama and Speaker Boehner, along with the other Congressional Leaders, will probably have to decide if a grand bargain of the type that eluded them in 2011 can be resurrected in order for tax reform to come to fruition next year.

With divided government and deep philosophical differences, a number of challenges to enactment of such legislation remain. But as a point of departure there is a lot to agree upon, beginning with widespread, bipartisan consensus that our corporate tax code is in need of significant reform. The corporate sections of the tax code are anticompetitive, with a high rate and a narrow base; to wit, the U.S. average combined federal-state corporate tax rate of 39.2 percent is the highest statutory corporate rate among the OECD countries, while a litany of complex deductions and credits brings the United States back to the middle of the pack with respect to average effective tax rates. (Effective rates also differ significantly between industries and companies). Together, these elements of the code are widely understood to both diminish and distort business investment in the United States. There also is consensus that the tax code as relates to individuals, including pass-through business entities, needs to be reformed, though less agreement exists as to what magnitude of changes are necessary. And significant disagreements persist as to whether, and to what extent, new revenue should be used for deficit reduction purposes as opposed to paying for marginal tax rate reductions. Although President Obama would have preferred to undertake comprehensive reform with Democrats controlling both the House and Senate, the process for tax reform will require significant bipartisan buy-in given a Republican-controlled House and narrowly divided Senate. President Obama has put forward broad ideas on corporate tax reform, while keeping the focus in individual reform on increasing taxes for upper-income individuals. Congressional Republicans are likely to insist that both robust corporate and individual reform occur simultaneously.

If an agreement with a basic framework is reached by the President and congressional leaders, the tax writing committees will begin work next year on the very important details of how to restructure the tax code. Those details will be difficult to agree upon, but much work has already been done. Serious discussions have been ongoing for months—they would not be starting anew. In addition, disagreements will not always be partisan fights. Often, they may be skirmishes between political constituencies, rather than left-right disagreements. The Tax Reform Act of 1986, for example, was accomplished with Democrats controlling the House, Republicans controlling the Senate, and Ronald Reagan as President.

Business Tax Reform

A considerable portion of the 2012 campaign was waged over taxes. Earlier this year, the Administration released a Framework for Business Tax Reform in which the President advocated reducing the top corporate rate from 35 to 28 percent, while providing manufacturers with additional tax preferences that would effectively lower their tax rate to 25 percent, with even lower rates for firms engaged in "advanced manufacturing." In addition, the Framework would expand, simplify, and make permanent the R & D tax credit. The Administration proposed revenue raisers to fully offset the cost of these changes. Specific items include repeal of Last In First Out (LIFO) accounting; repeal of tax preferences available for fossil fuels; limitations on tax preferences allowed for the purchase of insurance products, and by insurance companies; taxation of carried interest as ordinary income; and new rules that change the depreciation schedule for corporate jets from five to seven years.

Since those changes alone do not come close to paying for the proposed tax rate reduction, the Framework also includes a menu of options that, while short on detail, suggest the types of additional corporate tax base "broadeners" the Administration will pursue during tax reform. These include lengthening depreciation schedules; reducing the deductibility of interest as an ordinary and necessary business expense; and encouraging greater parity between large corporations and "large non-corporate counterparts" (presumably by subjecting some large pass-through entities to entity-level taxation).

International tax issues will be a significant focus in the tax reform debate, both with respect to the international operations of U.S. businesses and the treatment of inbound investment. In contrast to the Congressional Republican view that corporate reform should also be used to transition from a worldwide system of taxation toward a territorial system, the President's proposal would establish a minimum tax on U.S.-based multinational corporations' foreign earnings, eroding the use of "deferral" of foreign-source income. The Administration punctuates its position by stating that a "*pure* territorial system could aggravate, rather than ameliorate, many of the problems in the current tax code" (emphasis added). However, should corporate reform negotiations take place, it is likely this would be a point of negotiation with the Congress rather than a hard-and-fast view; rejecting a "pure" territorial system still leaves plenty of room for discussion with those who are seeking to move towards a territorial system, as most countries have neither pure territorial nor pure worldwide systems of taxation, but rather combine elements of both.

For their part, House and Senate Republicans will continue to push for a lower target corporate rate of 25 percent, working from a corporate tax reform draft proposal tabled in late 2011 by Ways and Means Committee Chairman Camp, who supports moving towards a territorial system. While that document focused on international taxation and did not spell out which revenue raisers might be utilized to buy down the corporate rate, there will assuredly be points of overlap between Congressional Republicans and President Obama on this front, including lengthening depreciation schedules.

In addition to the corporate tax provisions that have long been targeted by the Administration (*e.g.* LIFO accounting), numerous tax deductions, credits and preferences will thoroughly be examined during the tax reform process. For example, while Republicans will be willing to examine various preferences enjoyed by the oil and gas industry, they will certainly want to include in their examination tax incentives for renewable energy. In addition, they will consider whether the Section 199 deduction for domestic manufacturing should be eliminated to pay for lowering the corporate rate for all taxpayers.

Tax "extenders" will continue to be thoroughly vetted, a process that started earlier this year when Chairman Camp formally asked Select Revenue Subcommittee Chairman Pat Tiberi (R-OH) to lead a top-to-bottom review of the business, individual, and energy provisions that expire on a year-to-year basis. These approximately 80 provisions include the R & D tax credit, active financing exception for Subpart F income, New Markets tax credit, 15 year depreciation for qualified leasehold, restaurant, and retail improvements, and deductions for private mortgage insurance.

The purpose of the ongoing review of these provisions is to determine which ones continue to serve the policy purposes for which they were enacted. This process has thus far included two public hearings, but only modest legislative action. The Senate Finance Committee, which has marked up an extenders bill, dropped several extender provisions in the process.

Even assuming that most of these provisions will be extended through 2013, the tax committees have made clear that such an extension should not be viewed as a reflection of support for making these provisions permanent. Supporters of most extenders will bear the burden of demonstrating that they should be made permanent (as opposed to being eliminated with the resulting revenue used to lower rates across the board).Over and above extenders, additional items that will be on the table for discussion include major corporate tax expenditures, including the tax credit for low income housing, and the exclusion of interest on public purpose State and local government bonds. In addition, a significant item that will be discussed relates to the deductibility of interest as an ordinary and necessary business expense, which, if altered, could affect both U.S.-based companies and foreign companies with operations in the United States.

Individual Tax Reform

As mentioned above, the dominant feature of President Obama's plan is to income-limit the Bush tax cuts at the $200,000/$250,000 level. The Administration has been circumspect about other changes it would like to see, save for a proposal to further increase taxes on the same group of upper-income taxpayers by reducing the value of itemized deductions and exclusions to 28 percent. Taken together, these proposals would generate nearly $1.5 trillion to be utilized for deficit reduction.

Congressional Republicans will continue to push for revenue-neutral individual tax reform, though in order for a deal to materialize they will have to compromise to some degree. While also generally avoiding specifics, Republicans are somewhat more forward leaning in advocating robust individual tax reform whereby deductions (and perhaps exclusions) would be sharply limited in order to lower marginal tax rates, akin to the plan offered by Governor Romney during the campaign. Chairman Camp, Ranking Member Hatch, and others have noted that the differential between the top corporate rate and top individual rate should be minimized so as to avoid incentivizing sheltering of income through C-corporations as occurred pre-1986. While ideally they would prefer a top individual rate no greater than 28 percent, that target will be very difficult to achieve given that some new revenue will have to be earmarked for deficit reduction. This is especially so because, for both parties, significant political considerations will intervene as Congress sets about determining what deductions and exclusions it can eliminate or modify.

Those provisions likely to undergo the closest examination during reform are the litany of politically popular deductions from income currently allowed, including those for home mortgage interest, state and local property and income taxes, and charitable contributions. In addition, the committees may look to limit some tax exclusions, including those for interest on State and local municipal bonds, employer health care contributions, and retirement contributions for both defined benefit and defined contribution plans.

Estate Tax. In addition to income, dividends, and capital gains taxes, another significant item to be addressed in the context of tax reform is the federal estate and gift tax. It is likely that the current policy of a $5.12 million per individual exemption, indexed for inflation, and a 35 percent maximum rate will be incorporated into any agreement to extend the Bush tax cuts into 2013. While President Obama has proposed to reduce the exemption level to $3.5 million and increase the top rate to 45 percent, many Democrats in Congress support the agreement on the estate tax provisions that was reached in 2010.

Apart from possible changes in the rate and exemption levels, the Obama Administration has included in its previous budget submissions proposals that would scale back (or eliminate altogether) commonly used estate planning strategies, including the use of grantor retained annuity trusts and applying valuation discounts for certain types of assets in determining the size of an estate subject to taxation. While the Administration will likely continue to support such estate tax revenue offsets in its second term, these proposals to date have not gained traction due to strong opposition from family farm and business groups and Congressional Republicans. We therefore believe the odds favor permanent extension of current law beyond 2013, assuming a short-term extension later this year.

PPACA Taxes. The Patient Protection and Affordable Care Act (PPACA), enacted in 2010, included a number of tax increases that are scheduled to take effect in January. These taxes include several provisions that will affect taxpayers with adjusted gross income above $200,000 ($250,000 for married taxpayers), such as a 0.9 percent Medicare surtax on earned income and a 3.8 percent Medicare surtax on investment income. The legislation also included, among other revenue provisions, a 2.3 percent excise tax on medical devices. With President Obama having been reelected, changing any of the individual components of PPACA will be met with great skepticism by the Administration and Congressional Democrats alike. However, the House has passed, with the support of a significant number of Democrats, legislation introduced by Representative Erik Paulsen (R-MN) to repeal the medical device tax. While the Senate has not yet taken up that legislation, it is one of the few PPACA policies for which some bipartisan support for repeal exists, and thus could be addressed during tax reform.

Pension Reform. Two events will drive pension reform in the 113th Congress: Tax reform and expiration of the Pension Protection Act (PPA) at the end of 2014.

With Members of Congress on both sides of the aisle searching for new revenue sources, the tax-advantaged status of qualified retirement plans has been and will continue to be under scrutiny. During the past year, the key congressional committee staff, both majority and minority, have been building a foundation of retirement savings reform principles and options for both defined benefit and defined contribution plans. The bottom line of any change to the current system will be a general desire to avoid harming the current system—especially changes that will limit the long-term ability of workers to save for retirement. However, there are questions as to whether the cost of the program is too high—that is, whether, as Senator Baucus asked at a recent hearing on retirement savings, taxpayers are getting enough "bang for the buck"—and whether the private retirement system's tax benefits are properly allocated along the socio-economic spectrum of workers. At a more fundamental level the key issue is how to use the retirement system to broaden the tax base in a way that won't undermine its effectiveness and that is palatable to the American public.

In the run up to expiration of the PPA, the reauthorization debate will center on the need to modify the funding rules for single and multiemployer defined benefit plans. Multiemployer plans have been particularly hard hit by the weak economy, the aging participant workforce, and the consolidation of traditionally union industries that feed participation in these plans. The challenge here is to establish a framework for preserving the plans, relieving the funding burden on participating employers (who can be driven out of business by the escalating costs), and avoiding the label of a bailout.

Anticipated Agency and Administration Developments

Secretary of the Treasury. Secretary Tim Geithner is expected to step down next year. Given that the Secretary will have such a vital role in tax and entitlement reform discussions, the President is likely to choose a successor who is capable of helping drive a deal to completion. The Secretary will get significant input from Treasury staff as well as the staff of the National Economic Council.

Congress. Who, aside from the Congressional Leadership, will President Obama and the Administration be working with to advance fundamental reform? The leadership of committees with jurisdiction over tax issues will not change in the 113th Congress, with Representatives Dave Camp (R-MI) and Sander Levin (D-MI) continuing as Chairman and Ranking Member, respectively, of the House Committee on Ways and Means Committee, and Senators Max Baucus (D-MT) and Orrin Hatch (R-UT) continuing as Chairman and Ranking Member, respectively, of the Senate Finance Committee. Due to retirements, there will be several members added to both committees, though final committee ratios will not be set until later in the year or early next year. In addition, Vice Presidential candidate Paul Ryan, who will remain a senior member of the Ways and Means Committee and, likely, Budget Committee Chairman, will continue to be a highly influential thought leader for conservatives on all fiscal matters.

TECHNOLOGY AND COMMUNICATIONS

Streamlined Sales Tax, State Sales Taxation of E-Commerce. President Obama is expected to support new measures to capture revenue on sales by e-commerce companies. To fulfill his pledge to address debt reduction without compromising essential public services, a uniform system to collect sales taxes by states on e-commerce could present a promising opportunity to "close a loophole" created by the Supreme Court. States and localities face serious budget shortfalls and will face greater challenges as Congress is poised to make sizeable federal budget cuts. There is renewed interest on both sides of the aisle to provide struggling states with un-captured revenue.

As Congress adjourned for the November elections, sponsors of legislation that would allow states to collect sales tax on online purchases said they would seek a Senate vote during the remaining weeks of the 112th Congress. Senators Dick Durbin (D-IL), Mike Enzi (R-WY), and Lamar Alexander (R-TN) offered an updated version of their Marketplace Fairness Act (S. 1832), as an amendment to the Small Business Jobs and Tax Relief Act, but the effort failed to secure the necessary votes for inclusion in the bill. The sponsors will attempt to have the legislation included in other bills during the lame duck session and, if not successful there, will begin their effort again in the 113th Congress. Meanwhile, the House Judiciary Committee held a hearing on a companion bill, the Marketplace Equity Act (H.R. 3179), introduced by Representative Steve Womack (R-AR), but no action has been taken on that measure. The bill's authors must secure GOP support and overcome erroneous arguments that the legislation creates a new tax or amounts to a tax increase when the aim is simply to recover tax revenue that is already owed. Going forward, the focus of the discussion will be on the size of the small business exception contained in both the House and Senate bills. Critics of the legislation would like to see the exception increased from $500,000/$1,000,000 to $20/$30 million, while supporters counter that it should be closer to $150,000.

Telecom Act Rewrite. It has been seventeen years since the Telecom Act of 1996, the last major effort to reform the 1934 Communications Act (Communications Act) and foster a more competitive telecommunications market. Broadband deployments, technology, and marketplace developments have outpaced the statutory and regulatory grasp. Bipartisan calls for another "Telecom Act rewrite" are starting to come from a number of quarters, but there is clear recognition that reform is likely not a "one-session" task. Passing comprehensive telecom reform through regular order will require bipartisan cooperation because neither party has sufficient votes to overcome a filibuster if a vote occurs along party lines. If comprehensive reform is stymied, some reforms may push through individually.

Calls for a rewrite of the Telecom Act started after the U.S. Court of Appeals for the D.C. Circuit decided in the 2010 Comcast case that the FCC did not have authority to enforce informal net neutrality rules. Clarifying the FCC's authority to regulate the Internet will be one of the principal drivers to reform the Telecom Act. Another driver is consumer migration from traditional television and cable to online video delivery platforms. This development has brought into focus shortcomings of the twenty-year-old provisions of the Cable Television Consumer Protection and Competition Act of 1992. Both Chairman Rockefeller and current Communications Subcommittee Chairman John Kerry (D-MA) signaled that video competition policy reform is necessary to protect consumers. Senator Jim DeMint (R-SC), who will likely emerge as the lead Republican on the Commerce Committee in the 113th Congress, introduced the Next Generation Television Marketplace Act (S-2008) to repeal must carry mandates, retransmission consent, compulsory copyright licenses and media ownership rules. DeMint has an aggressive deregulatory agenda and has been considering comprehensive Telecom reform. Chairman of the House Subcommittee on Communications, Technology and the Internet, Greg Walden (D-OR), also recognizes that changes in the video marketplace may require reassessment of the law.

TRANSPORTATION AND INFRASTRUCTURE

The Obama Administration and 113th Congress will have a full transportation and infrastructure agenda. Having completed a long-term reauthorization of the nation's aviation programs in the 112th Congress, action will focus on implementation at the Department of Transportation (DOT) and, in particular, the Federal Aviation Administration (FAA). On the heels of a significant but short-term reauthorization of the nation's surface transportation programs, the incoming Congress will again confront the need to reauthorize or extend the nation's highway and transit programs—and the same fundamental question of how to pay for them. Rail issues will also be an important part of the agenda, including Amtrak funding and operational issues, the future of the Obama Administration's high speed rail initiative, and the impending compliance deadline for controversial Positive Train Control (PTC) requirements. Finally, water infrastructure may indeed be an area of increased focus, with Congress confronting the need to enact a Water Resources Development Act (WRDA) and exploring new innovative financing approaches to help meet the nation's large and growing water infrastructure needs.

Surface Transportation

<u>Major Issues</u>

On July 6, 2012, President Obama signed into law the Moving Ahead for Progress in the 21st Century Act (MAP-21), a two-year reauthorization of the nation's surface transportation programs. As MAP-21 extends only through September 30, 2014, the Obama Administration and 113th Congress will again confront the need to reauthorize or extend the nation's highway and transit programs and the fundamental question of how to pay for them.

The most important issue underlying the future of the surface transportation program is the financing question. Incoming revenue into the Highway Trust Fund, primarily from the gas tax, is insufficient to support current expenditure levels. The federal gas tax is set at a fixed 18.4 cents per gallon and has not been increased since 1993. At the same time, increases in fuel efficiency and changes in driving patterns due to higher gas prices have led to a decrease in gas tax revenue, resulting in an ever-widening gap between revenues and authorized spending levels. The Congressional Budget Office estimates this shortfall will further accelerate with implementation of the new Corporate Average Fuel Economy (CAFE) standards announced in August 2012.

Increasing the gas tax was not a consideration during the debate over MAP-21, reflecting the political forces that have kept the gas tax frozen in place for nearly 20 years—and that have been magnified by record gas prices and a sluggish economy. Just to keep the program at current levels, MAP-21 transfers $21.2 billion from the General Fund and other sources into the Highway Trust Fund. Since 2008, Congress has transferred approximately $56 billion into the Highway Trust Fund to maintain its solvency. Merely extending the program at current levels beyond September 30, 2014 is projected to require approximately $15 billion in additional revenue per year to supplement declining Highway Trust Fund receipts.

Against this backdrop, MAP-21 is a transitional bill, providing two years of funding certainty and time to address the fundamental long-term financing question—while also setting a policy direction for the future. Responding to the constrained funding environment, MAP-21 places a core focus on maximizing the value of existing resources. It expands innovative financing opportunities, increasing funding for the TIFIA low-interest loan program nearly tenfold. It broadens tolling opportunities and takes steps to facilitate public private partnerships (PPPs). It streamlines the environmental process to accelerate project delivery and encourages innovative delivery methods. It consolidates programs, and eliminates most discretionary programs, to give states and transit agencies more flexibility and certainty. It moves towards a more performance-based planning process to focus investments on achieving strategic outcomes. And it takes steps to define and prioritize systems that are in the federal interest, targeting over 60 percent of highway funding to preserving and improving an expanded National Highway System consisting of the nation's most important highways; and requiring the designation of a Primary Freight Network consisting of the nation's most significant freight corridors.
MAP-21 also authorized appropriations for a new Emergency Relief program at the Federal Transit Administration (FTA), paralleling the Federal Highway Administration's (FHWA) existing program. While there are available funds for FHWA's program, the current CR does not provide funding for FTA's program as it only extends existing appropriations from FY2012. In the aftermath of Hurricane Sandy, funding for both the FTA and FHWA Emergency Relief programs may be revisited as part of a potential supplemental appropriations bill during the lame duck session.

Forecast for the 113th Congress

While MAP-21 serves as a bridge, it ends at a crossroads. The Obama Administration and 113th Congress face three fundamental choices for the future of the program: (1) increasing the gas tax or raising dedicated new revenue from other sources; (2) reducing spending to align with available revenue; or (3) continuing the General Fund transfers and short-term policies that have sustained the program since 2008. These choices of *how* to finance and how much revenue to generate are in turn intertwined with questions of *what* to finance and what the federal role in transportation investment should be.

There remains broad opposition to an increase in the gas tax, especially given current prices at the pump. Neither the President nor the House or the Senate is likely to endorse one, especially standing on its own. There have been a wide range of other ideas floated on how to raise additional revenue. The President campaigned on a proposal to use the "peace dividend" from winding down the wars in Iraq and Afghanistan as a financing source. There have been various proposals to link transportation and energy revenues, either through new taxes on wholesale oil sales and speculative trading of oil futures (a Democratic proposal from the 111th Congress); or expanding domestic oil and gas drilling and devoting the new revenues to transportation (a Republican proposal from the 112th Congress). Others have proposed indexing the gas tax for inflation or converting the current fixed per-gallon tax to a percentage sales tax. There does not appear to be any political will for converting to a mileage-based fee or Vehicle Miles Traveled (VMT) tax, although many experts point to the VMT as the most sustainable and equitable long-term solution.

Another possibility receiving increasing attention is addressing transportation finance as part of a "grand bargain" or comprehensive fiscal reform package. In its final report, the Simpson-Bowles Commission recommended gradually increasing the gas tax by 15 cents over three years and limiting spending to those receipts. During the Super Committee process, the "Gang of Six" proposed maintaining the current gas tax but raising $133 billion over ten years for transportation as part of comprehensive tax reform. Turning to non-transportation revenue sources, however, raises separate concerns about departing from the user fee principle embodied in the gas tax. Because highways and transit are funded through a Trust Fund with their own dedicated user fee, the funding is not neither subject to annual appropriations— nor to sequestration— and authorizing legislation is able to provide guaranteed multi-year funding or "contract authority." If the user fee link is severed, so too may be the special budgetary status of the surface transportation program.

The other fundamental choice is to reduce spending to align with Highway Trust Fund receipts. Without additional revenue, spending would have to be cut by 30% to stay within available Trust Fund balances. There is a view that if additional revenue cannot be raised, the federal program has no choice but to live within its means and should be refocused on the core elements of the nation's transportation system – those of clear and longstanding federal interest. Those holding this view generally call for available revenues to be bolstered through further expansions in innovative financing, tolling and PPPs; and for federal requirements to be further streamlined to reduce costs and provide states with maximum flexibility.

Under continued Republican leadership, the House is likely to favor accelerating the direction set in MAP-21 and—under any funding level—will likely seek to prioritize investment in the higher order systems, further streamline the environmental process, and make greater use of tolling, innovative financing and PPPs. The Senate and Obama Administration will want to maintain the policy compromises established in MAP-21 and not go further. During consideration of MAP-21, for example, two of the most significant bi-cameral debates were about (1) the extent of environmental streamlining; and (2) whether to modify or eliminate altogether the set-aside for bicycle and pedestrian projects, which became a proxy for the broader debate about the scope of the federal program and federal role. In both cases, the House wanted to go farther than the Senate – and that dynamic is expected to continue. While the Republican House has generally been less supportive of funding for urban transit systems, MAP-21 confirmed there is a fundamental core of bi-partisan and bi-cameral support for dedicated transit funding.

Ultimately, the fundamental question facing the 113th Congress is whether and how to raise additional revenue, followed by the question of what the federal program will look like under the various constraints. In the 112th Congress, the Republican House, Democratic Senate, and Obama Administration grappled with these choices and in the end came together to enact a short-term bill that maintained current spending levels and relied upon another General Fund transfer.

The same players now return for the 113th Congress, but facing a greater challenge. The financing gap continues to grow, such that even another two-year bill at current levels would require some $30 billion in additional revenue. Policymakers will also have to address the reauthorization with only limited time to see the effects of the policies put in place in MAP-21. Short on the heels of MAP-21 and facing an even larger revenue shortfall, Congress will confront the future of the program with heightened recognition that fundamental decisions need to be made, but faced with difficult and complex choices.

With respect to key discretionary programs funded outside of the Highway Trust Fund, the President's re-election and return of a Democratic Senate provide the greatest likelihood that the TIGER program will be continued. The New Starts program will also continue to be a priority for the Obama Administration and Senate. Unlike programs funded through the Highway Trust Fund, however, the discretionary TIGER and New Starts programs are subject to sequestration and would be impacted by automatic across-the-board cuts should they occur. In the event of any cuts to the New Starts program, the FTA would be expected to prioritize existing Full Funding Grant Agreements and maintain those commitments, as it has historically.

Rail

Major Issues

Rail issues will be an important part of the transportation agenda in the next Congress driven, in part, by the decision not to include a rail title in the MAP-21 bill. That decision frees up the 113th Congress to focus on comprehensive rail safety and policy issues and, in particular, reforms to the Railroad Rehabilitation and Improvement Financing (RRIF) program; Amtrak funding and operational issues; the future of the Obama Administration's high speed rail initiative; and the controversial 2015 deadline for implementation of PTC requirements—a deadline that the Federal Railroad Administration (FRA) has said cannot be met.

Forecast for the 113th Congress

Congress has not enacted a major piece of rail legislation since the Passenger Rail Investment and Improvement Act (PRIIA) and Rail Safety Improvement Act (RSIA) of 2008, which established the 2015 PTC deadline. While both the House and Senate included rail policy titles in their respective surface transportation bills, they ultimately were unable to reach an agreement within the Conference timeframe and include a rail title in the final bill. With the impending PTC deadline serving as the main driver, but with a host of issues to address, the 113th Congress is likely to consider substantive rail legislation.

The release in August 2012 of FRA's Report to Congress on PTC implementation is the critical catalyst for legislative action. The report concluded that most railroads will not be able to meet the PTC deadline, citing significant technological and programmatic challenges. In addition to an extension of the deadline, Congress is expected to consider other strategies including phased implementation and options for "alternative technological compliance" to provide greater flexibility while achieving an equivalent level of safety.

In addition to PTC, Congress is also likely to seek reforms to the RRIF loan program. The RRIF program is widely regarded as being underutilized, and there is broad consensus that certain reforms—primarily to the application and review process—could substantially increase its effectiveness. Building on reform proposals developed as part of the surface transportation reauthorization, there is considerable bipartisan momentum behind efforts to reform the RRIF program and strong desire to see it function more like the popular TIFIA program.

Amtrak subsidies and operating practices will continue to be high-profile issues. While Governor Romney explicitly called for an end to Amtrak subsidies, the Obama Administration (and Vice President Biden in particular) along with the Democratic Senate have been strong supporters of Amtrak and will continue to prioritize funding to meet Amtrak's operating, capital and debt service requirements.

With respect to Amtrak operations, the House Transportation and Infrastructure (T&I) Committee under Chairman John Mica (R-FL) focused intensely on Amtrak's cost structure and put forward a proposal, along with Rail Subcommittee Chairman Bill Shuster (R-PA), for the privatization of the Northeast Corridor. While Governor Romney also expressly called for full Amtrak privatization during the campaign, a re-elected President Obama and Democratic Senate will continue to oppose privatization initiatives.

If Chairman Mica is not granted a waiver, it is widely expected that Chairman Shuster will take over the full committee. While it is unclear to what extent Chairman Shuster will pursue the proposal for privatization of the Northeast Corridor that he released along with Chairman Mica, the House is very likely to continue pressing for the use of competitive private sector contracting for Amtrak services such as food and beverage concessions and track maintenance work. The House has also highlighted the use of competitive private sector contracting for the operation of certain commuter rail routes and is likely to emphasize that as a model that should be expanded.

The future of the Obama Administration's high speed rail initiative will be another highly visible issue. President Obama has made high speed rail a signature transportation priority, and the 111th Congress provided $10.1 billion for high speed and intercity passenger rail projects across the country. Since the turnover in the 112th Congress, however, House Republicans have zeroed out the program and high speed rail has not received any further appropriations. The pending Senate transportation appropriations bill would provide a minimal level of funding ($100 million) to continue the program—a similar effort to what was proposed in FY2012 when ultimately no funding was provided. U.S. DOT, however, has used the TIGER program to fund targeted high speed rail projects to sustain some continued federal investment in this top Administration priority.

ALTERNATIVES: N/A

RECOMMENDATION: N/A

ATTACHMENTS: N/A